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BEFORE THE ARIZONA CORPORATION COMMISSION RECEIVED

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Arizona Corporation Commission

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IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR AN
ORDER OR ORDERS AUTHORIZING IT TO ISSUE,
INCUR, OR ASSUME EVIDENCES OF LONG-TERM
INDEBTEDNESS; TO ACQUIRE A FINANCIAL
INTEREST OR INTERESTS IN AN AFFILIATE OR
AFFILIATES; TO LEND MONEY TO AN AFFILIATE
OR AFFILIATES; AND TO GUARANTEE THE
OBLIGATIONS OF AN AFFILIATE OR AFFILIATES

Docket No. E-01345A-02-0707

STAFF'S INITIAL BRIEF

I. INTRODUCTION.

In this case, the Commission must determine whether it is in the public interest to authorize Arizona Public Service Company ("APS") to incur debt to finance assets that it does not own or operate. (Tr. at 63-64). Admittedly, this is an unusual request. (Tr. at 63-64, 107-08, 908-09). It is an outgrowth of the circumstances that currently exist in the financial markets, especially in the energy sector. (Ex. S-1 at 3; Tr. at 203-05).

In 2001, Pinnacle West Capital Corporation ("PWCC"), the parent company of APS, incurred approximately \$1 billion in debt in order to finance the construction of generating units at Pinnacle West Energy Corporation ("PWEC"), its merchant subsidiary. PWCC designed this debt to be short term in nature, because it anticipated that the APS generation assets would be transferred to PWEC at the end of 2002 pursuant to Decision No. 61973, the order that approved the APS settlement agreement. PWCC chose the maturities on its own accord. Once the APS generation assets were transferred, PWCC believed that PWEC would be able to support an investment grade credit rating and would be able to finance the debt at PWEC. PWCC then planned to retire the bridge debt as it

1 came due.

2 The Commission's decision in Track A, however, prevented the asset transfer.¹ Without the
3 APS generation assets, APS claims that PWEC will not have an investment grade credit rating and
4 therefore will not be able to finance the PWEC generation assets. (Tr. at 72). Because of market
5 conditions, APS also claims that PWEC will not be able to obtain project financing. *Id.* In the
6 meantime, the bridge debt at the PWCC level will come due beginning in 2003. All parties to this
7 proceeding agree that PWCC's bridge financing must be replaced. (Tr. at 87-88). The question
8 becomes how that should be accomplished.

9 APS' proposed "recovery plan" includes obtaining Commission authorization to execute
10 either of the following financings: 1) APS would borrow \$500 million and then loan it to PWCC or
11 PWEC; or 2) APS would guarantee \$500 million of PWCC's or PWEC's debt. (Ex. S-1 at 2; Tr. at
12 112, 217). After evaluating APS' application, Staff has concluded that the Commission should
13 authorize APS to borrow \$500 million in order to loan the proceeds to PWEC. This authorization,
14 however, should be subject to seven conditions that are designed to protect APS and its ratepayers
15 from any possible harm resulting from this transaction. (Tr. at 905). Finally, Staff recommends that
16 the Commission deny APS' request to guarantee the debt of either of its affiliates.

17 **II. AUTHORIZING APS TO BORROW \$500 MILLION IN ORDER TO LOAN THE**
18 **PROCEEDS TO PWEC OR PWCC MAY SERVE THE PUBLIC INTEREST BY**
19 **PROTECTING APS' CREDIT RATINGS.**

20 **A. If PWCC's credit rating is downgraded, it is likely that APS will suffer a similar**
21 **downgrade.**

22 In order to merit approval of its application, APS must establish that its proposed financing is
23 compatible with the public interest. See A.R.S. § 40-301.C. APS argues that, if its parent company,
24 PWCC, does not secure a loan or guarantee from APS, PWCC's credit rating will be downgraded by
25 the rating agencies. (Tr. at 72, 793). APS further argues that a downgrade to PWCC would result in
26 a downgrade to APS as well. (Tr. at 75, 794). And a downgrade to APS will likely mean that it will
be unable to obtain credit to support its utility operations. (Tr. at 27). This result could interfere with

27 ¹ APS witness Davis stated at least three times that, had he been a member of the Commission, he would have made the
28 same decision. (Tr. at 586, 597-99, 612). He also stated that it is not in the best interests of the State or of APS for
divestiture to take place (Tr. at 597-99).

1 APS' ability to provide electric service to the public. In these circumstances, the financing that APS
2 is requesting would be compatible with the public interest if it ultimately prevents a disintegration in
3 APS' ability to provide electric service. (Ex. S-1 at 4).

4 The question, then, is the likelihood of PWCC and ultimately APS actually suffering a credit
5 downgrade. Because neither event has occurred, the Commission is left to evaluate the various
6 witnesses' speculations as to what the credit rating agencies might do. (Tr. at 911-13). And although
7 it is impossible to predict the future, the evidence in this proceeding supports the conclusion that APS
8 is likely to suffer a credit downgrade if PWCC is downgraded. (Tr. at 75, 94).

9 Because the PWCC bridge debt will come due sometime in 2003, all parties agree that that
10 debt must be refinanced. (Tr. at 87-88). Panda Gila River, L.P. ("Panda") suggests that the bridge
11 debt be refinanced by PWCC. (See Tr. at 91). But APS contends that refinancing all of the bridge
12 debt at PWCC will be virtually impossible. (Tr. at 90, 110-11). And even if PWCC financed only a
13 portion of it, it would risk almost certain credit downgrades by rating agencies. (Tr. at 72, 93, 113).
14 As a consequence, APS could face credit downgrades simply because it is a subsidiary of PWCC.
15 (Tr. at 125-26, 155-56, 184, 186). Finally, APS contends that the Commission's denial of this
16 application will result in almost immediate ratings downgrades at both PWCC and APS. (Tr. at 219-
17 26). By contrast, both Standard & Poor and Moody's have issued statements indicating that APS'
18 credit quality would be unaffected by an APS financing. (Tr. at 92-93, 117-18, 166).

19 Panda witness Susan Abbott contends that, in order to avoid a downgrade, PWCC must
20 refinance, although not necessarily at APS. (Tr. at 744). She argues that PWCC and APS have
21 presented a "recovery plan" that focuses on APS providing the financing; consequently, the rating
22 agencies are focusing on that plan rather than on any alternatives. Id. However, on cross
23 examination, Ms. Abbott admitted that she does not know what the financial community's reaction
24 would be to any alternative recovery plan. (Tr. at 750). Nor does her testimony include any analysis
25 of PWCC's resulting credit matrix if it were to refinance the debt. (Tr. at 761-62). Finally, she
26 acknowledged that she does not know of any rating agencies that have indicated that PWCC will not
27 be downgraded if it attempts to refinance the debt itself. (Tr. at 763-64).

28 Staff concluded that there is some risk of ratings downgrades to PWCC and, as a

1 consequence, to APS. (Ex. S-1 at 4; Tr. at 911-13). Although we do not know for a fact that APS'
2 credit ratings will drop if this application is denied, several rating agencies have intimated as much in
3 their reports. (Tr. at 911-13, 745-51). Although the evidence on this issue is clothed in conjecture
4 and speculation, significant evidence nonetheless supports the conclusion that PWCC is at risk for
5 credit downgrades. As a consequence, APS faces a similar risk. Accordingly, Staff recommends that
6 the Commission authorize APS to borrow \$500 million in order to loan the proceeds to PWEC.

7 **B. Because of the risks inherent in this transaction, the Commission should attach**
8 **conditions to its approval of APS' application.**

9 Even though Staff has concluded that APS' proposed financing will likely serve the public
10 interest, the transaction poses some risks to the company and its ratepayers. In the coming years,
11 APS has significant needs for capital for its utility operations. (S-1 at 1, 5). Issuing debt to loan to
12 PWCC or PWEC will diminish APS' ability to obtain its own required debt capital. Id. The
13 proposed financing also runs counter to the goal of insulating APS from its affiliates' unregulated
14 activities. (Ex. S-1 at 3). Although these considerations do not outweigh the need to prevent a
15 downgrade to APS' credit rating, they do suggest that the application should be approved subject to
16 conditions. (Tr. at 905).

17 Staff suggests seven conditions that are designed to protect APS and its ratepayers from any
18 potential harm that might result from this transaction:

- 19 1) APS should be authorized to issue and sell no more than \$500 million of debt in
20 addition to its current authorizations.
- 21 2) The debt to be lent to PWEC should be no more than \$500 million of secured callable
22 notes from PWEC. The security interest shall be on the same terms as the security
23 interest APS already has pursuant to the \$125 million loan authorization from
24 Decision No. 65434.
- 25 3) The PWEC secured note coupon shall be 264 basis points above the coupon on APS
26 debt issue and sold on equivalent terms, including but not limited to maturity and
27 security.
- 28 4) The difference in interest income and interest expense should be capitalized as a
deferred credit and used to offset rates in the future. The deferred credit balance shall
bear an interest rate of six percent.
- 5) The PWEC debt's maturity shall not exceed four years, unless otherwise ordered by
the Commission.

1 6) Any demonstrable increase in APS' cost of capital as a result of the transaction, such
as a decline in bond rating, will be extracted from future rate cases.

2 7) APS shall maintain a minimum common equity ratio of forty percent and shall not be
3 allowed to pay dividends if such payment would reduce its common equity ratio below
4 this threshold, unless otherwise waived by the Commission. The Commission will
5 process any request for a waiver within sixty days, and for this sixty day period, this
condition shall be suspended. However, this condition shall not permanently be
waived without an order of the Commission.

6 (Ex. S-1 at 11-12).

7 Conditions 2 and 6 are designed to protect APS and its ratepayers from any potential harm
8 that may result from this transaction. Condition 2 will ensure that APS' interests are protected if
9 PWCC or PWEC were to default on the loan. (Ex. S-1 at 6). APS' application does not provide for
10 APS to have a security interest in the assets; yet, if a default were to occur, APS would have to
11 continue to make the interest and principal payments on the \$500 million of debt. Condition 2 is
12 designed to address this issue. Condition 6 is designed to put the company and its affiliates on notice
13 that any negative credit effects suffered by APS shall not be borne by its ratepayers. (Tr. at 923-25).

14 Conditions 3 and 4 are designed to ensure that APS and its ratepayers receive appropriate
15 benefits from this transaction. Although PWCC and PWEC are benefiting tremendously from this
16 transaction, it is more difficult to identify specific benefits to APS and its customers. APS may argue
17 that it will benefit by avoiding a credit downgrade, but Staff believes that it is APS' duty as a public
18 utility to maintain an appropriate credit rating. As APS' application currently stands, this transaction
19 will expose APS to risk without providing its customers with any extra benefits commensurate to that
20 risk. Conditions 3 and 4 are designed to remedy this inequity. Condition 3 ensures that APS will be
21 compensated for the risk associated with lending money to PWEC. (Ex. S-1 at 6; Tr. at 102, 919-20,
22 991-92). Condition 4 provides that the difference between interest income and interest expense shall
23 be used to offset rates in the future. (Ex. S-1 at 12; Tr. at 906-07, 991-92, 935-36).

24 Conditions 5 and 7 are designed to provide appropriate regulatory insulation, i.e., separation,
25 between APS and its affiliates. Condition 5 intended to prevent APS from financing PWEC's assets
26 indefinitely. (Tr. at 920-22). Condition 7 is designed to ensure that APS will continue to be properly
27 capitalized even if one or more of its affiliates experiences financial difficulties. (Tr. at 917-18).
28 Although all seven conditions are important, condition 7 is especially so. (Tr. at 905-06, 917-18).

1 Under ordinary circumstances, Staff would probably recommend that this application be
2 denied. (See Ex. S-1 at 2, 4-6; Tr. at 944-45). However, the circumstances surrounding this
3 application are far from ordinary. The financial markets are deteriorating, the energy sector is in
4 disarray, electric utilities in neighboring states have suffered financial difficulties, and the wholesale
5 market for electricity has been volatile. Against this backdrop, the Commission's policy should be
6 aimed at ensuring that Arizona will continue to have financially sound electric utilities. Because of
7 the potential risk of a downgrade to APS' credit rating, the Commission should approve APS'
8 application; because of the potential risks inherent in this transaction, the Commission should
9 condition its approval upon Staff's seven conditions.

10 **III. THE COMMISSION SHOULD DENY APS' REQUEST TO GUARANTEE DEBT**
11 **ISSUED INDEPENDENTLY BY PWCC OR PWEC.**

12 Panda, one of the intervenors to this proceeding, contends that, if the Commission determines
13 that the financing is in the public interest, it should deny APS' request to structure the financing as an
14 intercompany loan and should instead require the transaction to take the form of a guarantee. (Tr. at
15 38-39, 46-47). Staff opposes this result and recommends that the Commission approve this
16 application only as an intercompany loan, not as a guarantee. (Ex. S-1 at 7; Tr. at 906). Staff
17 opposes the guarantee because it is undefined, impractical, ill suited to the circumstances of this case,
18 and unsupported by the record.

19 APS' application does not define or price the proposed guarantee, and APS has admitted that
20 the guarantee option has not been developed. (Ex. S-1 at 7; Tr. at 199, 906, 915). Without these
21 terms, it is impossible to evaluate it in any meaningful way. Staff is also concerned about the timing
22 of a guarantee. APS claims that it needs to complete this transaction as soon as possible. (See Tr. at
23 987). If that is true, a guarantee is not practical, because of the additional time that it will take to
24 develop its terms and complete the necessary regulatory reviews. (Tr. at 9870-88).

25 Even if the guarantee were well defined, Staff continues to believe that a loan will better
26 protect ratepayers' interests. Staff prefers an explicit loan at a stated interest rate that expressly sets
27 forth the risk to which APS will be exposed. (Ex. S-1 at 7). APS witness Gomez stated that the
28

1 guarantee option is problematic because of the continuing turmoil in the financial markets. (Tr. at
2 203-05). As the markets continue to deteriorate, banks are getting more reluctant to lend, especially
3 in the energy sector. Id. Although APS acknowledges that a guarantee is possible, their witnesses
4 indicated that it is more complicated than a loan. (Tr. at 121-22, 565-68). Clearly, a loan will serve
5 the same purpose as a guarantee, yet result in a less cumbersome transaction. (Tr. at 565-66, 915).

6 The guarantee option also interferes with Staff condition 2, which requires APS to hold a
7 security interest in the PWEC assets. (S-1 at 11; Tr. at 906, 931, 933-34). APS witness Gomez said
8 that a guarantee might have benefited PWEC by giving it an entrée into the financial markets. (Tr.
9 at 121). In other words, PWEC could have attempted to raise capital in the markets subsequent to
10 this financing and could have secured those offerings by interests in its plant. Id. But Staff's
11 requirement that APS hold a security interest in the plant eliminates this benefit. (Tr. at 122). Staff
12 believes that APS should hold the first security interest in the assets: a secondary position is contrary
13 to the ratepayers' interests. (See Tr. at 123-25, 906).

14 Panda argues that a guarantee will maintain separation between APS and its affiliates and will
15 better preserve the potential for meaningful wholesale competition in Arizona. (Tr. at 39, 46-47).
16 Neither argument merits foregoing the certainty and simplicity of a loan for the uncertainty inherent
17 in a guarantee. (See Tr. at 906, 915).

18 In an ideal world, we would have complete separation between APS and its affiliates.
19 Unfortunately, we must deal with the facts as they exist, not as we would like them to be. APS'
20 holding company, PWCC, is not a recent creation. The PWCC enterprise structure is almost entirely
21 the result of PWCC's choices, its history, and its business plan; however, some might consider it to
22 be due to the Commission's competition rules, which gave utilities the option of transferring their
23 generation assets to an affiliate. See A.A.C. R14-2-1615.A.

24 Although Staff believes that regulatory insulation is important, it is unreasonable to structure
25 this transaction around that single goal. First, it is not likely that a guarantee will provide the degree
26 of separation that Panda seeks: even if lenders have a security interest in PWEC's assets, they may be
27 more likely to pursue APS' guarantee in the event of default. (Tr. at 196-97, 208-09). Further, Staff
28 believes that several of its conditions, notably conditions 5, 6, and 7, will do an excellent job of

1 addressing this issue. In summary, Staff opposes structuring the transaction as a guarantee merely to
2 enhance the degree of separation between APS and its affiliates.

3 Although Panda contends that approval of APS' proposed loan to PWCC or PWEC will
4 undermine the Track B solicitation, it overlooks the timeline for that solicitation. That process will
5 very likely be underway within the next month, possibly before an order in this case has even issued.
6 Under these circumstances, it is hard to conclude that this financing proposal will interfere with
7 Track B.

8 Without question, the Commission remains committed to promoting a competitive wholesale
9 market. Nonetheless, this is not the Commission's only significant policy goal. It is clearly in
10 Arizona's public interest to have financially sound electric distribution utilities. And Staff believes
11 that the potential risk to APS' credit rating, although somewhat speculative, warrants Commission
12 approval of this application.

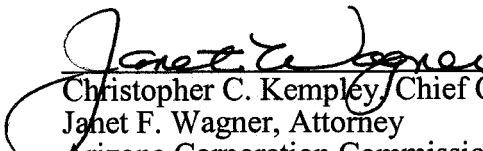
13 **IV. CONCLUSION.**

14 Staff recommends the following:

- 15 1) The Commission should authorize APS to borrow \$500 million in order to loan the
16 proceeds to PWEC.
- 17 2) The Commission should condition its approval of this application upon Staff's seven
18 conditions set forth on pages 11-12 of Exhibit S-1.
- 19 3) The Commission should deny APS' request to guarantee any debt issued
20 independently by PWCC or PWEC.

21 RESPECTFULLY SUBMITTED this 27th day of January 2003.

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